DOW THEORY LETTERS INC.

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THE MARKET: As suggested in the last Letter, the market, following its 77 point Industrial plunge of January-February, was ready to rally. The same Letter stated that it would not be surprising to see the Dow retrace one-third to two-thirds of its recent 77 point decline. Such a rally could bring Industrials back to the 855-870 area.

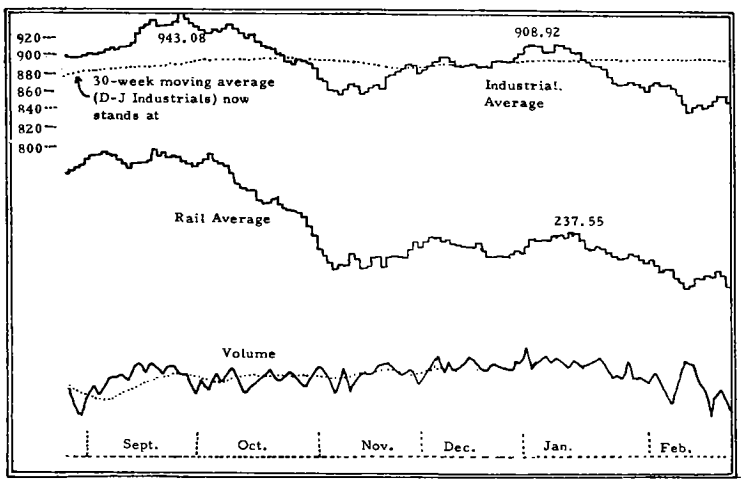
Referring to the chart at the bottom of this page, it is notable that the 30-week moving average of Industrials has now turned down. The moving average is currently in the 888 area, and this represents a definite reversal of investment sentiment. We can now say that the average price which informed investors are willing to pay for high-grade stocks (i.e., Dow-type stocks) is declining, and that the Industrial Average is now substantially below its moving average. This type of situation and relationship has not been seen since the declining phase of the 1966 market.

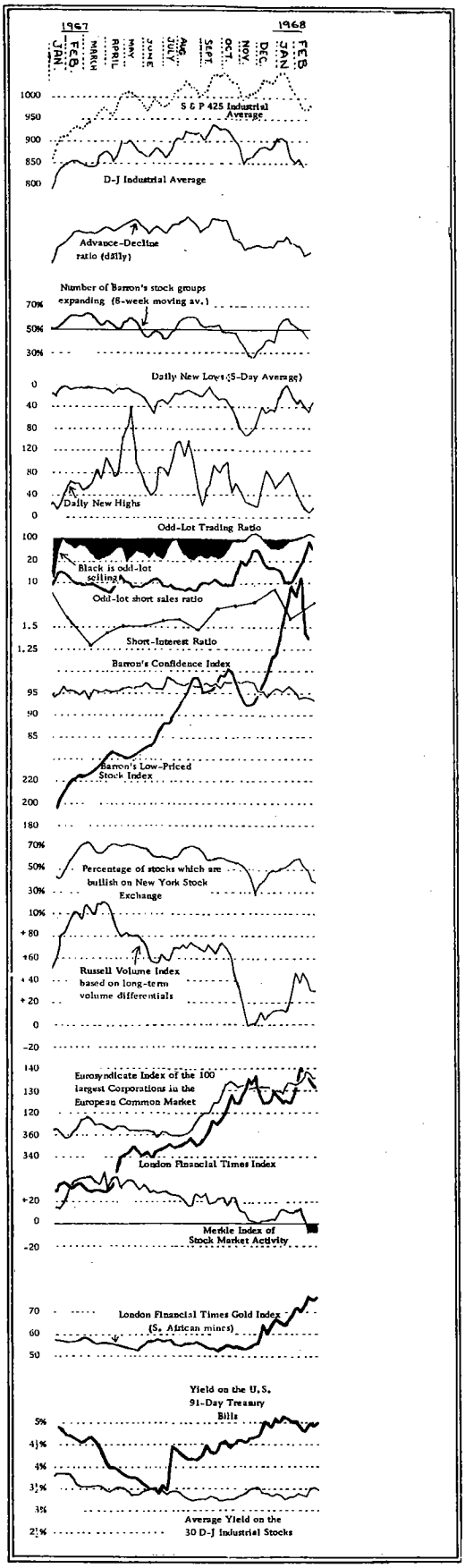
Referring to the composite page 1 chart, the Russell Volume Index has broken out of its recent consolidation pattern on the downside. Confirming this, the Merkle Index is in minus territory for the first time since late 1966. Odd-lotters are on the buy side of the market for the first time since last November. The number of stock groups expanding has dropped to 39%, and the number of stocks in bullish trends on the N.Y.S.E. has dropped to 42%. All in all, these indicators present a negative picture, and despite the rally, they suggest that there will be more downside action to come.

PERSPECTIVE: As most subscribers know, I am of the opinion that people on Wall Street often do not see the forest for the trees. It is the nature of a primary bear trend to establish a long series of declining tops and declining bottoms. As long as this action continues, the bear market is in progress.

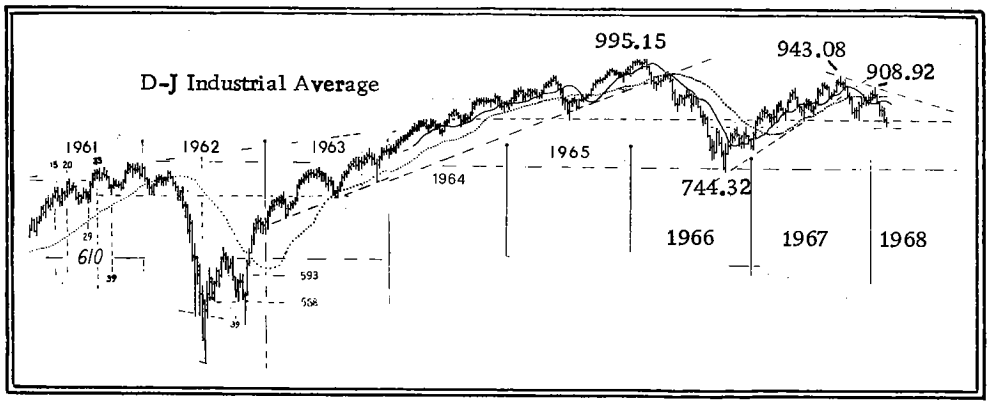
Between the period of February, 1966 and October, 1966, the classic bear market description of successive lower tops and bottoms was met exactly. Then the rally from the 1966 lows began, and once more the bear market definition was put to the test. The rally from the '66 lows lasted eleven months, terminating at 943.08 on September 25, 1967. In other words, the rally halted 52 points under the historic 1966 high.

In late September, 1967, a new decline got underway. By November the Dow




1967
1968
S & P 425 Industrial Average
D-J Industrial Average
Advance-Decline ratio (daily)
Number of Barron's stock groups expanding (8-week moving av.)
Daily New Lows (5-Day Average)
Daily New Highs
Odd-Lot Trading Ratio
Black is odd-lot selling
Odd-lot short sales ratio
Short-Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Percentage of stocks which are bullish on New York Stock Exchange
Russell Volume Index based on long-term volume differentials
Eurosyndicate Index of the 100 largest Corporations in the European Common Market
London Financial Times Index
Merkle Index of Stock Market Activity
London Financial Times Gold Index (S. African mines)
Yield on the U.S. 91-Day Treasury Bills
Average Yield on the 30 D-J Industrial Stocks

had dropped to a low of 849.57 (see chart, courtesy of Quote Digest, 110 No. Lorraine, Wichita, Kans.). From the 849.57 low, the Industrials rallied to the January, 1968 peak of 908.92. Thus, as seen on the chart, we had three descending tops, 995.15 (1966), 943.08 (1967) and 908.92 (1968). But in order for the pattern of the bear market to be reconfirmed, we also require new lows. The target for the bear market is now the 744.32 low established in October, 1966.



It follows that we are now in what Dow Theorists term "secondary territory". We are between the 1966 high and the 1966 low. The primary trend, under Dow Theory, is always conceded to be in the direction of the last confirmation, and the last confirmation was bearish. Therefore, considering the pattern of the Averages alone, I take the position that we are still in a primary bear market.

Although I place great importance on the phases, psychology, time element, etc. (see last Letter) no one can actually prove we are still in a bear market until the two Averages, Industrials and Rails, reconfirm the primary bear trend by breaking their last primary lows. In other words, a full reconfirmation of the primary bear market would require an Industrials closing below 744.32 and a confirming Rail closing below the 1966 bear market low of 184.34.

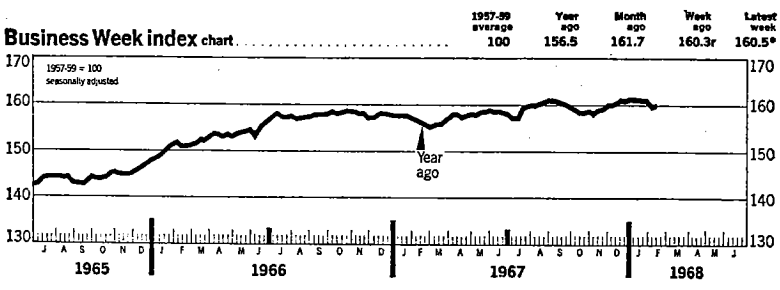
It is of interest that the total drop from the historic 1966 high of 995.15 to the 1966 bear market low of 744.32 was 250.83 points for the Dow. The halfway level of that 250.83 point drop was 869.74 on the Dow. Subscribers know that I usually attach great importance to what the Dow does at the halfway level of any major rise or decline. This is in line with Dow's 50% Principle.

During the great bear market rally of 1966-67, the Dow pushed to 943.08, a full 73 points above the halfway level of the 1966 decline. I feel that the Industrials were "helped" back over the 50% level by the momentum of the greatest speculative spree in Exchange history. However, it is worth noting that when the speculation was interrupted, the Dow immediately dropped back under the 869.74 or halfway level. Thus, we are currently nearer the 1966 low on the Dow than the 1966 high. I consider the recent Industrial plunge below the 50% level of the 1966 range to be basically bearish. It suggests to me that we will not see another approach to the 1966 highs for many years to come.

THINGS TO COME: During a bear market, the "normal" state of events is for business to deteriorate. Slackening business is not yet apparent in this bear market, but the uncomfortable signs are beginning to show.

January industrial output dropped for the first time in four months. There was nothing actually surprising in this. We could see hints of it in auto sales, which auto executives now admit are running at a 7.6 million rate per year. We could see it perhaps more dramatically in steel production. Here, with steel labor contracts up for negotiations in a matter of months, there are few signs of advance steel inventorying. Absence of a pre-negotiations steel build up is something that has not been seen since World War II. The lack of forward steel buying is ominous, and the sluggish action of the steel stocks reflect it.

The fact is that despite the war in Vietnam, despite the calling up of additional manpower periodically, the economy is not showing signs of a heightened boom. On the contrary, it is wallowing in the residue of last year's excitement, and the next general direction of economic activity is most likely to be down (note the sluggishness of Business Week's Business Index).



As the bear forces begin to express themselves, I expect the whole unpleasant picture to become much clearer to the public. It will be harder to mask the economic holes, it will be much more difficult to hide the mess underneath. Here are some of the bear market-making events which I foresee presenting themselves during 1968. (1) Government spending will continue to skyrocket. Rising costs (some built in as a result of current programs, others new and unforeseen) will throw the national budget further out of kilter than ever. With this will come Government needs for giant new sources of funds. Interest rates will surge upward again as the Treasury enters the bond market for more and more money. I consider the current "breather" in the bond market a mere transitory easing of interest rates brought on by an easing in general business conditions. It will be followed by another Government-sponsored credit crunch (see later bond section).

(2) The Communists will keep the heat on, for they are well aware of our domestic financial problems. If the heat does not come from escalation of the war in Vietnam itself, it will come from Korea, Cambodia, Laos or even the Middle-East or the Mediterranean. It is becoming increasingly obvious that Hanoi will negotiate only on its own terms; meanwhile it is leading the U.S. on in a "cat-and-mouse" game as I have stated many times before in these Letters. Furthermore, Hanoi's ace-in-the-hole is the U.S. economy, and they know it. They will keep the pressure on until the bear market has taken its toll and the urge to get out of Asia becomes well nigh irresistable. The big danger— U.S. frustration and final use of nuclear weapons, which would almost certainly bring China into the war.

(3) A bearish factor is that the Republicans seem incapable of coming up with anyone to beat LBJ. Another term for LBJ would mean more of the same, and "the same" is bearish for the market, the economy and the international situation.

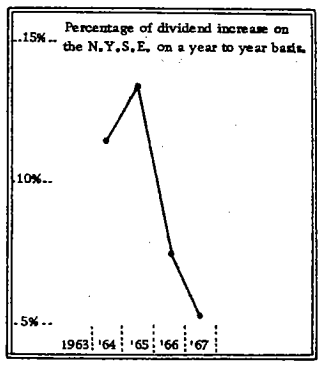
(4) I agree with economist Eliot Janeway who draws attention to the fact of increasing costs in the face of decreasing volume and stable to lower selling prices for American industry. For decades industry has been able to absorb increased costs through rising volume and inflation in selling prices. This has changed, and it is going to hit profits dramatically.

(5) The easing in the economy in the face of expanding Government costs (both domestic and war) is making for the next major trouble on the monetary front. Any drop-off in Government tax receipts will mean vastly stepped-up needs for financing. The place where that financing will take place is the bond markets. For this reason, I have distrusted the faltering rally which has lifted almost all debt securities off their late-1967 lows.

(6) Nothing has been settled or even vaguely settled on the monetary front. Japan and Canada are possible devaluation candidates, with France and South Africa also candidates for a different reason. In the case of France and S. Africa, any devaluation would be undertaken as pressure calculated to upset the monetary applecart and ultimately force the price of gold upward. Whether any of these four potential devaluations occurs now or not, each is a distinct and bearish possibility and further monetary dislocations mean trouble for U.S. corporations with important foreign subsidiaries.

(7) Finally, there is the bearishness inherent in the giant psychological fragmentation which has swept the country. Within my memory, I have never seen so much resentment, anger, ferment, potential trouble. "What seems to be wrong with the American people?" is the question coming from every politician and sociologist. A vast discontentment has enveloped the nation, and its implications are bearish. A disregard for law and an explosion in the crime rate are its symptoms, but the true danger extends much further than mere personal resentment or actions.

DIVIDEND PAYOUT DROPPING: Cash payments on N.Y.S.E. listed stocks were good in 1967, but as in so many market studies, it is the trend which is most important. I drew this chart covering the past four years, and I found it interesting.



The 1967 dividends showed a 5.3% increase over 1966, while 1966 showed a 7.3% increase over 1965. The year 1965 bettered 1964 by a whopping 13.3% while 1964 bettered the 1963 dividend payouts by 11.5%. Thus, as seen on the chart (which measures percentage of dividend increase on a year to year basis), the trend of increase is dropping. It is entirely possible that 1968 will actually see a net decrease in dividend payout compared with 1967. In this case, the chart would go into the minus area.

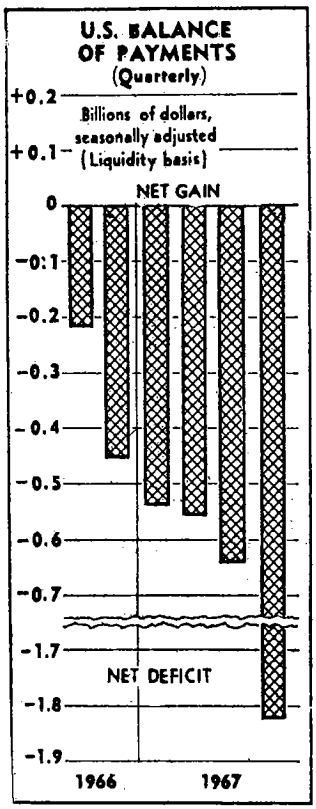
It is worth noting that the peak of dividend increases on a year to year basis occurred in 1965, the year the high-grade stocks topped out and just prior to the February 6, 1966 historic high of 995.15 on the Dow.

BONDS: I do not share the current majority opinion regarding bonds, namely, that the worst has been seen in the bond market and that from here on the trend of bonds will be higher (or that the trend of interest rates will be lower).

As I see it, the current slight dip in short-term interest rates stems from the easing in bank borrowing and the high-level sluggishness in business. But the bigger picture is one of constant need to defend the dollar, one of these defenses being high interest rates. The accompanying chart (page 4) pictures the U.S. balance-of-payments during the last six quarters, and any words I could add regarding this chart would be superfluous. Suffice it to say that it is a horror. The chart is saying that U.S. interest rates "should" be boosted through the roof in an effort to cut back domestic business and imports as well as to hold back inflation, thereby gradually making our exports more attractive. But no action on the interest rate front has been forthcoming. It may come yet, however.

Another reason for distrusting the current level of interest rates is the constant devaluation threat. To fight a weakening dollar and the threat of devaluation a nation needs high interest rates, interest rates so attractive that foreigners will want to keep their money in that currency at those high interest rates. Any major foreign devaluation would mean that the dollar would have to be immediately defended— with higher interest rates.

On top of this, the new round of escalation in Vietnam calls for more money and more built-in deficits in coming months. The potential explosion in Korea has pointed up the limited capacities of the U.S. to handle new trouble spots, and this too adds to the potential need for further spending.



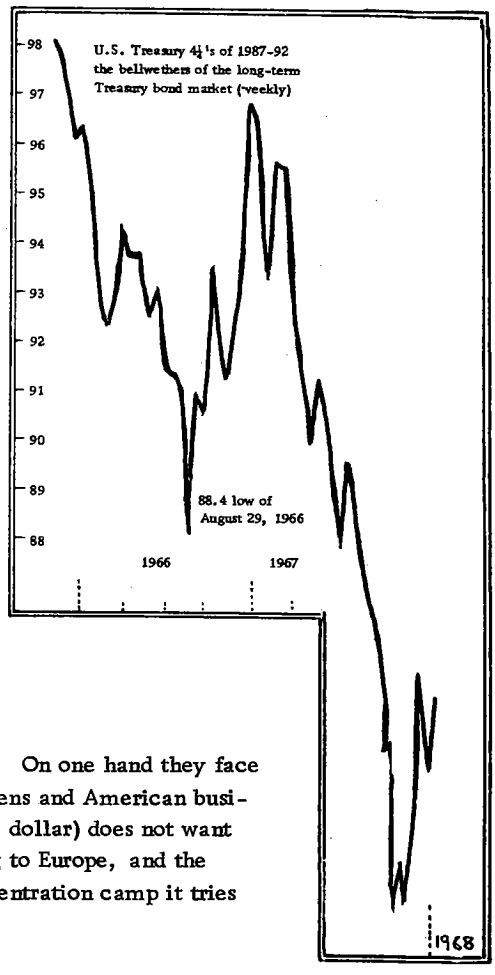
This is an election year, and we have a "guns-and-butter" president who is committed to a sort of token Great Society in the midst of a big-money war. We have an Administration which has never yet faced the fact that its spending estimates always fall short of the facts. We have an Administration which is spending and projecting on the basis of a surtax (which has not yet been acted upon) and corporate tax receipts which may well be below expectations (in case readers forget, lower corporate receipts and therefore tax receipts do happen to be characteristic of bear markets).

In all, as things are now going, I believe the bond market is in for its biggest trouble yet. That trouble should hit before 1968 is over. I include a chart of the bellwether 4¼ Treasury bonds of 1987-92, and here we see the tremendous collapse of 1966-67. We also see the recent 1967-68 rally which has taken the bonds back from the 1967 low to a recent high just above 85.

Two factors could produce a bottom in the bond market, and they are these. First, a termination of the Vietnam war would lessen the Government's need for money and undoubtedly set off a major rise in the bond market. Second, an increase in the price of gold (if that increase was large enough) would boost the value of our gold reserves and allow for further perhaps important inflation. This too, could have the effect of setting off a major bond rise (since it would ease interest rates).

But given the current trend of events, I see new lows in bonds over coming months. So far, this observer would prefer to treat the recent rise in bonds from their 1967 lows as nothing more than a technical rally after one of the worst bond collapses on record.

MOST PITIFUL WORDS OF THE WEEK DEPARTMENT: From Secretary of the Treasury Henry Fowler last week before the House-Senate Economic Committee: "Our deficit is going up to $33 million a day (without a tax increase), let's get this bird in hand. If you can then, reduce Federal expenditures more, well, God-speed to you.....While we're waiting and waiting and waiting, we've lost $4.5 billion in additional revenues. Meanwhile, I'm the one who has to go out and borrow the money to pay the bills."



NOTES AND QUOTES: Editor James Reston in the February 7 New York Times: "War is a corrupting business— always has been— and this one is no exception. But it is important to decontaminate the propaganda. No doubt the allied victories are true. No doubt the enemy casualties are very heavy. No doubt the civilian casualties are alarmingly high, though they are not mentioned.

"But the destruction goes on. We are the flies that captured the flypaper. We are stuck with our concept of a military victory, and the main question goes unanswered: What is the end that justifies this slaughter? How will we save Vietnam if we destroy it in the battle? "

* * * *

In a new book written by North Vietnam's leading military mastermind, General Giap, a point is made which I have often stressed here. Giap looks upon the current war as the mere conclusion of a thousand years of struggle to free Vietnam from the "invaders." Those invaders, states Giap, were the Chinese (for most of that period), the French and now the Americans. Those who believe that Hanoi is going to take its beating and then settle for some sort of happy compromise are whistling in the wind. Hanoi wants the Americans out of Vietnam. That's what they are fighting for, and the U.S. better start realizing this fully.

* * * *

The Johnson administration is caught in a squeeze on the balance-of-payments front. On one hand they face a hostile Congress which does not like restrictions on the freedoms of American citizens and American business. On the other hand they face a hostile Europe which (although it wants a stable dollar) does not want trade restrictions erected against it. In the meantime, masses of dollars are moving to Europe, and the U.S. Government is learning that money is like people, when it is placed in a concentration camp it tries to get out. Money, like people, seeks freedom.

Last week Oscar Altman, treasurer of the I.M.F. stated another side of the problem: "If the new measures do not create inconvenience and discomfort in the United States," he said, "if they do not put pressure upon the balance of payments of the major industrial countries, and especially those that have had long-continued surpluses in their balance of payments, they will not be effective."

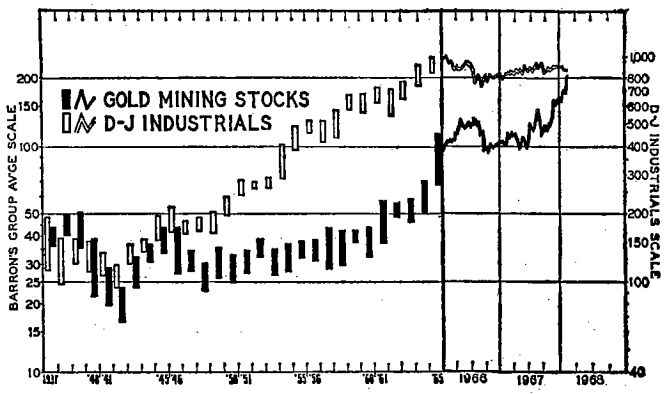
* * * *

From Alden R. Wells' latest (March) Monetary Report: "The stockholder will note that the Dow Jones Industrial Average has declined 16% in the two years of greatest governmental expenditures. Although gold mines are injured by inflation, gold stocks have appreciated over 50% in the same period. In the monetary field, there is a worldwide move toward liquidity. Individuals and governments buy gold when they can. Bankers try to reduce and upgrade loans. Borrowers are more cautious. In the United States a very large increase in savings has occurred in the past year. These tendencies gradually become translated into business statistics.

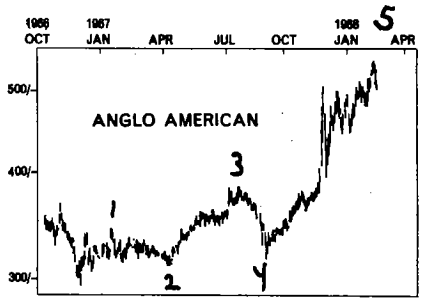
"The owner of gold stocks must ask (1) do our leaders understand that deflation is occurring?, (2) do they know what to do about it?, and (3) do they have the courage to act? Our answer is 'no' to each of these three questions. Consequently we continue to recommend both the holding and purchase of gold stocks as the best hedge against developing troubles."

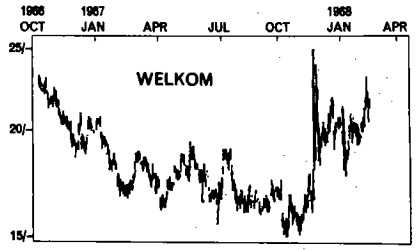
DOW THEORY MARKET LABORATORY PAGE

The accompanying chart put out by Dow Jones is of considerable interest. It shows the path of the Industrial Average and the Gold Mining Index since 1937. Note that from 1937 to 1945 the two averages kept pretty much in harmony with each other; an investment in golds was about as good an an investment in the Dow. From 1945 to 1961 the Dow far outpaced the gold shares as the forces of inflation and higher earnings worked for the Dow while a fixed price for gold and higher mining costs worked against the golds.



Then the picture changes, and from 1961 to the present golds began closing the gap (in other words, the relative strength of the gold group began to rise). In 1968 a significant development took place. The price of the Gold Index and the Dow almost touched, this for the first time since 1946. In other words, an investment in the golds and the Dow between 1946 and the present would have yielded comparable profits. Actually, since the Gold Index was considerably lower than the Dow in 1942, an investment in the golds would have yielded greater percentage gains (from 1942 to date) than an investment in the Dow. Few investors realize this fact.





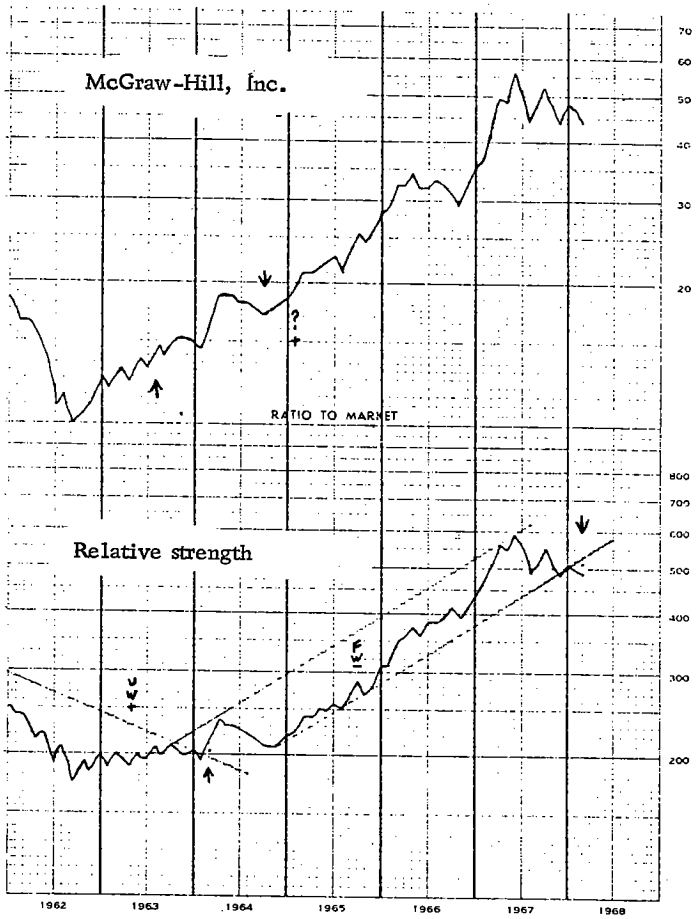
As this is written, while the Dow dropped over 7 points today, American South African and Homestake have risen to all-time highs while Campbell Red Lake and Dome are within eighths of their highs. Subscribers might remember my warnings in recent Letters not to attempt to trade the golds. Golds are in a primary advance and neither the duration nor the extent of a primary movement can be predicted in advance. I have suggested that subscribers who own golds allow these stocks to fully express themselves in their primary uptrend. To trade them is to run the probable risk of losing the most important part of the rise.

FOLLOW UPS: Charts of the South African shares are extremely difficult to come by, and I generally publish them when I am lucky enough to obtain updated graphs. Included are Anglo American, the huge trust which was recommended recently. This stock is following the familiar Elliot bull market pattern, having completed four legs of the probable five-leg pattern. Often, the fifth leg will be the speculative leg of a major bull movement and as seen on this logarithmic chart, the ground gained in the current leg five has surpassed all the gains of the first four legs. A great, speculative fifth leg may break down into five separate

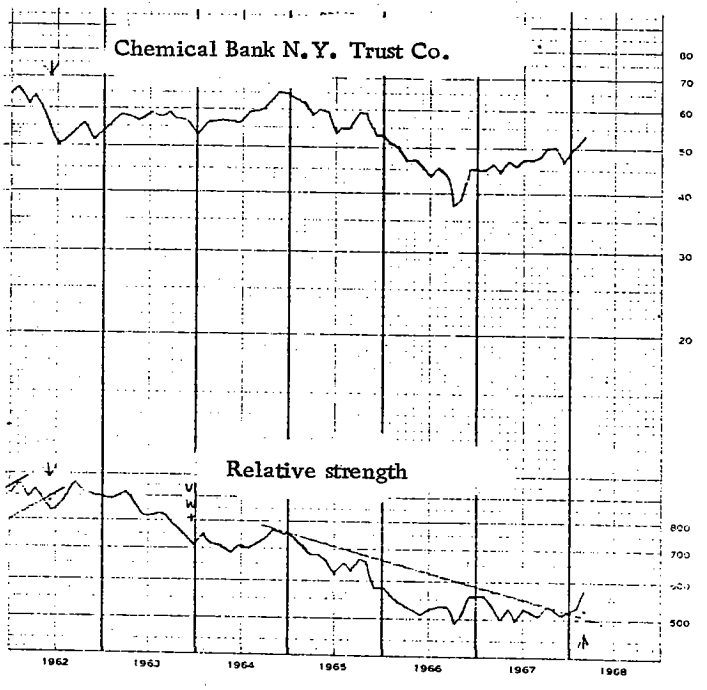
legs, and this is what we may be seeing on Anglo. The stock is currently in the 74 area, and I would continue to hold this one.

Welkom is one of the few gold shares which has been unable to better a previous important peak, but the long downtrend seems to have been reversed and a new bullish movement started. This stock is now bid $3.12 and I would continue to hold positions. (Charts courtesy of The Investor, 354 Kennington Rd., London, S.E.11).

STOCK NOTES: Much is being written today about the merit of bank stocks, following their long price decline since 1962-64. Somehow, I am not impressed with the outlook for banks, particularly in the face of what I consider a gathering credit crisis. However, for the benefit of market students two bank stocks have now reversed long-term declines in their relative strength charts. These are Chemical Bank and N.Y. Trust Co., and Fidelity Philadelphia Trust Co. (this does not constitute a recommendation). I show a chart of Chemical (courtesy of Ray Signals, 141 Broadway, N.Y.C.). Here we see a reversal of a five-year downtrend in relative strength, the implication obviously being that Chemical is now acting better than the market. Relative strength trends, then they are decisive as is the one pictured here, usually last for some time (I would be surprised if Chemical did not act better than the market for the next year or so, at least). Remember, this does not mean that the price of Chemical is going up, it merely suggests that Chemical will do better than the market on the upside and the downside.



A group which is now worth discussing is publishing. Here, the Government's pull-back in higher education plus the drafting of many young men is effecting the publishing business via a cutback in textbooks. Giant McGraw-Hill is a publisher which will be very much affected by a contraction in textbook sales, and its stock is discounting trouble ahead. Having outperformed the market since 1962, McGraw has now decisively penetrated its rising relative strength channel on the downside (see chart). This should constitute a warning to all holders of publishing stocks (particularly where there is a large textbook interest) to dispose of their holdings.



SILVER: I'll admit it, after recommending many silver issues during 1964-66, I cooled off on them, thinking they were too high (I sold my own Day Mines and switched the money to gold shares). My feeling was that in an economic slump, use of silver would decline while a slump would heighten interest in gold. I never suggested that subscribers sell their silvers (happily), and the chart of Day Mines (courtesy of M.C. Horsey) shows why I am happy. The stock has tripled since I first recommended it (and bought it) at 8. Day recently broke out of a huge ascending triangle (see chart). Those who hold it can rest in the knowledge that it is one of the strongest looking stocks around.